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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF OREGON

In Re:) Bankruptcy Case No.
) 04-60346-fra7
FIDUCIARY EDUCATIONAL SOCIETY,)
) MEMORANDUM OPINION

Debtor.)

In this cautionary tale we learn that there are limits to the Court's equitable authority. For the reasons set out below, the Trustee's motion seeking substantive consolidation with various non-debtor entities must be denied.

I. BACKGROUND

1. The Debtor

Fiduciary Educational Society (FES) is a trust created in 1991 by Rick Prescott and Roy Fritts, acting as trustees of National Trust Services (NTS). While the declaration of trust sets out in detail the trustors' aspirations that the trust advance the tenets of the Bible and the Constitution, it omits such specifics as the identities of the trustees, the specific duties of the trust, or the identity of any beneficiary. As discussed in more detail below, the trust was ultimately funded by NTS and Fountainhead Global Trust

1 (FGT), which conveyed real property in Josephine County, Oregon, to
2 FES as "fiduciary" for FGT. However, before getting to that point,
3 the narrative should turn to NTS and FGT, the entities the trustee
4 seeks to absorb into this bankruptcy.

5 2. NTS and FGT

6 *Bilgewater, I am the late Dauphin!. . . .Yes, my*
7 *friend, it is too true - your eyes is lookin' at this*
8 *very moment on the pore disappeared Dauphin, Looy the*
9 *17, Son of Looy the 16 and Marry Antoinette.*

10 - *Adventures of Huckleberry Finn*, Chapter XIX

11 Just as Huck and Jim were introduced to European royalty on
12 the Mississippi, so were investors introduced to the world of
13 personal trusts and high stakes investing by Rick Prescott and Roy
14 Fritts. National Trust Services was created to sell potential
15 investors on the notion of creating complex family trusts to manage
16 their assets. A colorful brochure was created, replete with
17 quotations from the founding fathers, bogus legal citations¹, and
18 glowing, but unattributed, endorsements from the "many thousands
19 already in the NTS trust system." The brochure, in several pages of
20 small type, describes the benefits of "the unique NTS program,"
21 including "basic knowledge, skills, training and 'how-to' approaches
22 - along with your custom designed NTS trust document." However, the

23 ¹ The pamphlet cites "Crocker v. MacCloy, 649 U.S.Supp. 39
24 270" as authority for the proposition that "a trust relationship
25 comes under the realm of equity, based upon common law, and is not
26 subject to legislative restrictions as are corporations and other
organizations created by legislative authority." The Court has
searched in vain for anything resembling the cited case. Of course,
there is no "U.S.Supp.."

1 actual nature of the services, or of the trusts to be created, is
2 not described.

3 The pamphlet does describe the career of NTS founder Roy
4 Fritts. Mr. Fritts is said to be the recognized world authority on
5 complex trusts, having previously undertaken "a major historical
6 effort for establishing a legal precedence on each and every vital
7 issue of the trust," employing a \$24 million budget. He had been,
8 investors are told, contract manager at The World Bank, developer of
9 the entire city of Crystal Springs, Florida, founder of 12 multi-
10 million dollar businesses, Businessman of the Year of the American
11 Management Association, a member of the California Bi-Centennial
12 Commission, and, a man of "impeccable integrity" whose life story
13 demonstrates "his great faith in God and his genuine desire to be a
14 servant to others."²

15 Investors are invited to avail themselves of Mr. Fritts'
16 skills, and those of Mr. Prescott and others, at a two-day workshop.
17 At the workshops, participants are trained in the ways of personal
18 trusts, use of the unique NTS program, and led to take the first
19 steps into the world of trusteeship and investing by creating their
20 own trusts, funded with their own (and, occasionally, other family
21 members') assets. The fee for the instruction, copious materials,
22 counseling and creation of the trust was \$9,500.

24 ²Testimony at the hearing described Mr. Fritts as a
25 disenchanted, if not estranged, heir of the Mellon family. One
26 witness testified that Fritts told him that Fritts' family owned the
Philadelphia office of the Internal Revenue Service.

1 3. Fountainhead Global Trust

2 At training sessions held in the Cayman Islands,
3 investor/trustees are introduced to Fountainhead Global Trust. FGT
4 was created by a declaration of trust by and between NTS and Messrs.
5 Prescott and Fritts, and one Joe Little, as trustees. The
6 beneficiary is NTS. The purpose of the trust was to serve as NTS's
7 "investment arm", and to invest funds supplied by members of the NTS
8 family of trustees.³ Over time FGT (if its own numbers are to be
9 believed) collected approximately \$20 million from 160 families.
10 The families were guaranteed, in various literature and at seminars
11 (or "Academies", as styled in the literature), returns of three to
12 four percent *per month*. Trustees, after sending in their money,
13 received receipts, but little else. Investors were apparently not
14 given much information regarding the manner in which FGT employed
15 their money. A number of people did receive some returns, but the
16 whole thing came to a crashing halt in 1999.

17 In October 1999 investors received a letter from Mr. Prescott
18 advising that payments would be suspended pending investigation of
19 defalcations by Mr. Fritts. The precise problem is not described in
20 any particular detail. Investors eventually were told that
21 Fountainhead Global had invested a substantial portion of their
22 funds in an entity called Cash for Titles. CFT was placed in the
23

24 ³ Only NTS trustees, that is, people who had paid the \$9,500 to
25 have trusts created, were eligible to invest through FGT. This
26 assured an exclusive service for the investors, and a tested and
proven market for FGT.

1 hands of a receiver for liquidation in an action brought by the
2 Securities and Exchange Commission. Investors were told that they
3 should make claims against the receivership to get their money back.
4 However, it does not appear that very many were able to do so.
5 While the record is unclear, it seems likely that most of the
6 investors' money is gone.⁴

7 Accusations flew between Mr. Prescott and Mr. Fritts,
8 culminating in an action brought in the Circuit Court for Josephine
9 County, Oregon, by Fritts against Prescott. Fritts eventually
10 abandoned the case. If he has been heard from since, no mention of
11 it has been made on this Court's record.

12 4. FGT and FES

13 As noted, FES was formed as a "charitable" trust, ostensibly
14 to carry out eleemosynary activities for FGT before NTS. Its assets
15 consisted largely of real property in Josephine County, Oregon,
16 acquired by FGT and conveyed to FES. Presumably the money used by
17 FGT to acquire the land came from investments from NST-minted
18 trusts; however, the evidence on this point is sketchy. The
19 trustees by this time were Mr. Prescott, Mr. Fritts, and Ivan
20 Cermak. After Mr. Fritts' departure, Peter Thompson was appointed
21 trustee. A letter from Ivan Cermak, as trustee of FES, to the
22 "Board of Trustees" of FGT states the conditions of the acquisition
23 of the largest parcel, known as the "Deer Creek Ranch":

24
25 ⁴Other acquisitions by FGT included an Internet startup called
26 Bigger.net, which failed, a huge cache of food being held somewhere
in Utah, and the Oregon real estate eventually transferred to FES.

- 1 1. FES will acquire and take title to the property for
2 a sum not exceeding three million dollars
3 (\$3,000,000).
- 4 2. FGT will provide the necessary funds for such
5 acquisition out of various funds under its control.
- 6 3. FGT will retain the right to hypothecate
7 (mortgage) said property as suits FGT. On such
8 occasion(s), FES shall pledge said property as
9 security for these FGT transactions, provided however
10 that FES will take on no financial obligations other
11 than the pledge of the property.
- 12 4. FES agrees to manage the property as Fiduciary
13 [sic].
- 14 5. FES will have full, unrestricted use of the
15 property, the intended use being the establishment of
16 an Education Center to suit its charitable purposes.
- 17 6. Should financial conditions require FGT to sell
18 said property, FES shall, on thirty days' notice,
19 cooperate in such sale. The proceeds of such sale
20 shall revert to FGT. [See Exhibit 8, page 39/91]

21 The trustees apparently had a falling out, and Messrs. Cermak
22 and Thompson moved to expel Mr. Prescott as a trustee. Prescott
23 initiated litigation in Josephine County. In a separate suit, FGT
24 sued FES in the Circuit Court, claiming a right to have the title
25 transferred by FES to FGT. The Circuit Court found that FGT was
26 entitled to summary judgment in its favor with respect Deer Creek
Ranch. Specifically, the Court found that there were no genuine
issues with respect to the following:

- a. The promissory note dated June 25, 1998...is
consistent with and supported by documentation in
evidence....
- b. The promissory note provides that, for value
received of \$2.65 million, defendant Fiduciary
Education society ("FES") will "retitle" the property
at 1241 Illinois River Rd, escrow No. 98111802KJ, back
to plaintiff Fountainhead Global Trust ("FGT") and one
other organization upon the occurrence of specified
"events of default." The escrow number referred to is
the transaction by which FGT and other organizations
transferred the sum of \$2.65 million into escrow for
the purchase, in FES's name, of Deer Creek Ranch.

1 b. [sic] Deer Creek Ranch comprised seven separate
2 parcels of land, which upon purchase were titled in
the name of Ivan Cermak as trustee of Fiduciary
Education Society.

3 c. The money used to purchase the Deer Creek Ranch
4 for FES was provided by Fountainhead Global Trust
(FGT) and the other organizations controlled by
5 plaintiff. None of the money used to purchase the
Deer Creek Ranch was provided by FES.

6 d. One of the events that constitute a default under
7 the terms of the promissory note is "the application
8 for appointment of a receiver" for FES. This event
occurred when the litigation in Josephine County
Circuit Court case no. 99CV0422 initiated by Roy
Fritts resulted in FES's assets being placed into
receivership.

9
10 (Judgment of the Circuit Court for Josephine County,
Oregon, Newman, J., in case No 02CV0522, filed May 20,
2004)

11
12 Judge Newman's decision was announced by letter on January
13 14, 2004. On January 20, 2004, before the Court had a chance to
14 enter its judgment, FES filed for relief under Chapter 11 of the
15 Bankruptcy Code. The petition was executed by Ivan Cermak as
16 trustee. The largest claimants disclosed in the schedules were Mr.
17 Cermak and Mr. Thompson, another trustee. No mention is made in the
18 schedules of creditors of FGT or its investors.

19 FES removed the Josephine County litigation to this Court.
20 FGT sought, and received, an order remanding the case to the Circuit
21 Court. Three of FGT's investors then filed an involuntary petition
22 against FGT, which was contested. At the hearing, it was determined
23 that one of the petitioning creditors was ineligible, and that the
24 petitioning creditors had failed to prove that a second petitioning
25 creditor was qualified. The involuntary petition was dismissed.

Given the confusion regarding the identity and authority of FES' trustees, the Court ordered parties to show cause why a trustee should not be appointed, or the case converted to one under Chapter 7. At the hearing, the debtor-in-possession waived any objection to appointment of a trustee, and the Court directed the United States Trustee to designate a Chapter 11 trustee. However, the UST was unable to find someone willing to serve in that capacity, and moved that the case be converted. It was so ordered, without objection from the Debtor.

The Trustee has now moved for an order substantively consolidating the existing case with the assets of FGT, NTS, and other entities.

II. DISCUSSION

Substantive consolidation involves the aggregation of assets of the Debtor and other entities into a single pool. Claims against any of the entities are paid from the pool. In re Bonham, 229 F.3d 750, 764 (9th Cir. 2000). Substantive consolidation, particularly when opposed by an entity being brought in, is a purely equitable remedy, and one which should be allowed only in extraordinary situations. In re Lease-A-Fleet, Inc., 141 B.R. 869 (Bankr. E.D. Pa. 1992). Given the risk to the interest of creditors in forcing creditors of one debtor to share with creditors of a less solvent debtor, substantive consolidation is not to be seen as an instrument of procedural convenience, but rather something that goes directly to the substantive rights of the parties. In re Augie/Restivo Baking Co. Ltd., 860 F.2d 515, 518 (2nd Cir. 1988).

1 Under Bonham, the party seeking substantive consolidation
2 must demonstrate either that (1) creditors dealt with the entities
3 to be combined as a single economic unit and did not rely on the
4 separate credit of each of the separate entities, or (2) the
5 operations of the entities were "excessively entangled" to the
6 extent that consolidation would benefit all creditors. Bonham, 229
7 F.3d at 766; In re Central European Industrial Development Co. LLC,
8 288 B.R. 572, 576 (Bankr. N.D. Ca. 2003).

9 The sole purpose of substantive consolidation is to ensure
10 the equitable treatment of all creditors. In considering this
11 point, courts have looked for a number of factors, including:
12 whether the debtors were independent of each other; whether
13 creditors dealt only with one debtor and lacked knowledge of its
14 relationships with others; whether there were consolidated financial
15 statements; the difficulty in segregating individual debtor's assets
16 and liabilities; the existence of transfers of assets without
17 observation of corporate formalities; and whether the affairs of the
18 debtors are so entangled that consolidation would benefit all
19 creditors. See Augie/Restivo, 860 F.2d at 518, and cases cited
20 therein.

21 Finally, substantive consolidation is an extraordinary remedy
22 with no basis in the statutory structure of the Bankruptcy Code.
23 Given the extraordinary nature of the remedy, a party seeking
24 substantive consolidation should demonstrate that the goals of
25 consolidation cannot be met by other means.

1 Substantive consolidation is not appropriate in this case,
2 for the following reasons:

3 1. Consolidation would prejudice FES' creditors.

4 The claims register reveals that several trade creditors have
5 outstanding balances, and that two of them have been reduced to
6 judgment. There are also a number of claims made by investors of
7 Fountainhead Global. Nothing in the claims actually filed with the
8 Court provides any evidence that FES is liable with FGT on the
9 claims of FGT's investors. Substantive consolidation would have the
10 effect of diluting the straight-forward claims of FES' trade
11 creditors, to their prejudice. FGT's creditors have no claim
12 against FES purely by virtue of the fact that FES' property was
13 being held for FGT's benefit. Their claims should be made in a
14 direct proceeding against FGT. (More on that below).

15 2. Relationship of FGT and FES.

16 The litigation in this court and in the Circuit Court in
17 Josephine County reveal a struggle between two opposing camps for
18 control of the debtor's assets. The agreement between the two
19 entities made it clear that FES' rights to the Ranch property were
20 limited. For all intents and purposes FES was no more than a
21 caretaker, given the right to possess and use the property for
22 purposes approved by FGT, and only so long as it suited FGT.

23 In this respect, this case is distinguishable from Bonham and
24 similar cases. In Bonham, an individual running a ponzi scheme
25 created many different entities to collect and hold funds collected
26 from victims. She would dip into one or more of these entities as

1 her needs required. In other cases, the entities being consolidated
2 had already been run as a single economic unit, or were used by a
3 single person or group of people for their own benefit, without
4 regard to corporate formalities. The individual in control sought
5 bankruptcy relief, and the court ordered consolidation of the
6 subsidiary enterprises.

7 This case would be similar to Bonham if FGT had been the
8 debtor, and the trustee sought to bring in assets of FES. However,
9 matters here are the other way around; the subordinate entity,
10 acting through two of its three trustees, filed its own petition in
11 an attempt to take control of assets to which the senior entity,
12 FGT, had been found by a court to be entitled to recover. The
13 dubious purpose of the petition is highlighted by the fact that the
14 schedules listed Cermak and Thompson has holding large claims, with
15 no reference to the FGT investors.

16 Where the original petition is suspect, compounding the abuse
17 of the bankruptcy system by application of the equitable doctrine of
18 substantive consolidation is not appropriate, even in light of the
19 fact of inequitable conduct by the entities sought to be absorbed.

20 3. Procedural concerns.

21 The remedy sought by the Trustee gives rise to significant
22 procedural difficulties. Specifically, it is not clear who would
23 control the consolidated Debtor. Unlike Bonham and similar cases,
24 the entities to be consolidated here are controlled by two distinct
25 and mutually hostile factions. So long as the case is in Chapter 7
26 this might not be a problem. However, it is not clear that the new

1 consolidated debtor would not have the right to convert the case
2 back to Chapter 11 in light of the fact that the bulk of the assets,
3 claims, and ownership rights related to the consolidated estate were
4 not involved at the time the case was converted from Chapter 11 to
5 Chapter 7.

6 4. Availability of other remedies.

7 There is nothing in the Bankruptcy Code which specifically
8 authorizes substantive consolidation. The Court of Appeals has
9 described the theory as "emanating from the core of bankruptcy
10 jurisprudence," Bonham, 229 F.3d at 764. The rule is, ultimately, a
11 judicial gloss based solely on the Bankruptcy Court's powers as a
12 court of equity. In re Augie/Restivo Baking Company, Ltd., 860 F.2d
13 at 518. Exercise by a trial court of its equitable authority is a
14 matter of discretion. In re Munoz, 287 B.R. 546, 552 (9th Cir. BAP
15 2002) (internal citations omitted).

16 For equitable relief to be available, it is generally
17 required that no adequate legal remedy is available. Continental
18 Airlines, Inc. v. Intra Brokers, Inc., 24 F.3d 1099, 1104 (9th Cir.
19 1994), Mort v. U.S., 86 F.3d 890, 892-93 (9th Cir. 1996).

20 The Trustee acts for FES's estate in bankruptcy, and stands
21 in the shoes of its creditors. It is not entirely clear what the
22 Trustee wishes to accomplish with substantive consolidation. If it
23 is simply to recover the property lost in the Josephine County
24 litigation, then substantive consolidation is clearly inappropriate.
25 The matter was duly determined by a competent court in litigation
26 that was substantially complete before the FES petition for relief

1 was filed. It has been established that the subject property
2 belongs to FGT, and not FES, and this court does not have authority
3 to undo that determination. Substantive consolidation is not
4 available as a tool to reel the property back in.

5 The tenor of the Trustee's trial memorandum and argument at
6 trial suggests that he is also interested in ensuring some recovery
7 for FGT's investors. The Trustee cannot be faulted for desiring
8 this result⁵: however, there are a number of steps that the
9 investors can take which are better suited to these circumstances.
10 Assuming that grounds can be substantiated, remedies at law may
11 include:

- 12 - actions under state law by investors to recover funds
- 13 delivered to FGT;⁶
- 14 - actions under State or Federal Securities laws;
- 15 - an action in State Court to remove FGT's current trustees,
- 16 or to dissolve the trust; or
- 17 - an involuntary bankruptcy of FGT or its principals.⁷

18
19 ⁵ A line of questioning from FGT's counsel, wisely not pursued
20 in closing argument, suggests that the Trustee is motivated by a
21 desire for a substantial commission. There is no evidence to
22 support this implication, and no reason to believe that the Trustee
is not performing in the manner expected of him by this Court.
Moreover, any commission earned by a trustee in the case envisioned
by the motion would be hard-earned indeed.

23 ⁶ That such claims may be subject to a limitation of actions
24 defense is immaterial. Equity does not favor those who stand on
their rights.

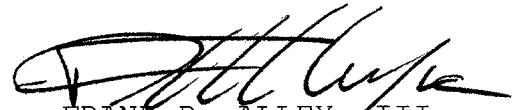
25 ⁷ As noted, the previous involuntary bankruptcy was dismissed
26 (continued...)

1 To the extent the investors are creditors of FES, the trustee
2 has the same remedies available to him. 11 U.S.C. § 544. If they
3 are not, then the trustee has no cause to invoke the court's
4 equitable powers to consolidate.

5 III. CONCLUSION

6 The Trustee has not sustained his burden of proof that
7 substantive consolidation is appropriate. While FGT's conduct, and
8 the losses it has caused, are deplorable, its misconduct does not
9 justify expansion of this case through substantive consolidation.

10 The foregoing constitutes the Court's findings of fact and
11 conclusions of law. An order will be entered denying the Trustee's
12 motion, and dissolving the restraining order imposed by the Court at
13 the close of the hearing in this matter.

14
15
16 
17 FRANK R. ALLEY, III
18 Bankruptcy Judge

19 cc: David Mills
20 Keith Boyd
21 Ron Sticka
22 Gail Geiger
23

24 ⁷(...continued)
25 upon a finding that one or more of the petitioners was not
26 qualified. This leaves roughly 158 families not bound by the
decision.